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UNCLAS SECTION 01 OF 03 BRASILIA 003207

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SUBJECT: BRAZIL - ECONOMY CONTRACTS, CRITICISM EXPANDS

REF: A) BRASILIA 3150

B) BRASILIA 3092

C) BRASILIA 3043

11. (SBU) Summary: Brazil's economy contracted 1.2% in the third quarter of 2005, falling further than even the pessimists had predicted. Growth expectations for the year, therefore, are being downgraded to the 2.3% to 2.7% range. The unexpectedly abrupt fall in GDP has intensified criticism of the Central Bank from across the political spectrum. Prominent orthodox economists have joined the chorus of disapproval, arguing that the Central Bank was over-zealous in its monetary tightening earlier in 2005. While there is a palpable sense of disappointment here that Brazil will not repeat its strong 2004 GDP growth performance (4.9%), the new growth projections are not far below the 3% level that most analysts believe is Brazil's maximum sustainable (and non-inflationary) level of growth in the medium term absent significant reforms to increase productivity. Moreover, growth in 2006 has a good chance of being stronger as current interest rate cuts spark a positive credit cycle and the GoB places greater emphasis on spending. The lack of any progress on President Lula's microeconomic reform agenda in Congress and a clear downward trend in investments, however, suggest there is little hope for sustaining faster growth rates. End Summary.

12. (U) Brazil's economy contracted 1.2% in the third quarter of 2005, according to recently released GoB data. Parsing the numbers, the quarterly growth data (see table below) show, on the demand side, declines in investment and government consumption. The supply side saw sharp drops in agriculture (-3.4%) and industrial output (-1.2%), while services showed no movement (0% growth). While overall export growth continued to be strong in spite of the appreciation of the Real, there is some evidence that price-sensitive agricultural exports, such as bulk grains, were damaged by the exchange rate; it also has contributed to a fall in planted area for the upcoming crop. Along with exports, the only bright spot in the third quarter numbers was personal consumption, which grew 0.8%. Private sector analysts now are predicting overall GDP growth for 2005 will be between 2.5% and 2.7%; the latest Central Bank poll of market expectations shows an average predicted growth of 2.66%. Meanwhile, a Planning Ministry think-tank (IPEA) has issued an even lower growth estimate of 2.3% for the year.

Brazilian GDP
Percent Growth - Seasonally Adjusted

	Annual/1		Quarterly Growth/2			
	2003	2004	4Q04	1Q05	2Q05	3Q05
Total GDP	0.5	4.9	0.8	0.2	1.1	-1.2
Supply Side						
- Agriculture	5.0	5.3	0.8	0.4	1.7	-3.4
- Industry	-1.0	6.2	0.9	-0.8	1.4	-1.2
- Services	-0.1	3.3	0.6	-0.2	1.2	0.0
Demand Side						
- Consumption						
(Private)	-3.3	4.1	1.1	-0.2	0.9	0.8
- Govt.	0.6	0.1	0.5	0.3	0.9	-0.4
- Investment	-6.6	10.9	-2.8	-3.1	4.7	-0.9
- Exports	14.2	18.0	4.4	2.8	2.6	1.8
- Imports	-1.9	14.3	3.6	2.5	1.9	1.4

/1 Percent Change on Previous Year

/2 Percent Change on Previous Quarter, Preliminary

Source: Statistical and Geographic Institute (IBGE)

Chorus of Disapproval

13. (SBU) The negative growth result has intensified criticism of the Central Bank from across the political spectrum. While not questioning the basic thrust of monetary policy, several prominent orthodox economists, among them former Central Bank President Arminio Fraga and former director Sergio Werlang, have criticized the extent of the Central Bank's interest rate hikes. These saw the benchmark SELIC overnight rate jump to 19.75% and real interest rates reach about 13%, a level local economists claim are the highest of any major economy in the world. The Central Bank's monetary policy committee (COPOM) will almost certainly cut the SELIC target rate by 50 basis points at its December 13-14 meeting, to 18%, continuing its current cycle of monetary easing, which began in September. Some Central Bank directors have lashed out at the Brazilian Statistical and Geographic Institute (IBGE), questioning (with some justification) the reliability of the IBGE estimates. Lula and Palocci both have publicly backed the Central Bank and its continued independence to set interest rates.

Role of the Weak Dollar/Strong Real

14. (U) The strengthening Real, which in recent months has consistently traded at relatively appreciated levels against the dollar (a band between 2.15 and 2.3 Reals per dollar), may be beginning to affect price-sensitive agricultural exports. There is anecdotal evidence that the strong Real is affecting investment decisions at the margins. One recent prominent example was a decision by Arcelor, reported in the press on November 29, to cancel a joint venture project with Brazilian mining giant CVRD to build a steel plant in the state of Maranhao due to the strong Real, which reduced the expected competitiveness of the plant's export-destined production. China's Baosteel, according to the press, also cited the appreciated Real when it called off its plans to construct a steel plant in the northeast. While these are only anecdotal data points, the fall in investments (-0.9%) in the third quarter IBGE data was the third such contraction in the last four quarters and suggests that investment is on a clear downward trend. This raises concerns about the foundations for future growth.

Will 2006 Be Better?

15. (SBU) Not all the data was negative. Carlos Mussi, an economist with the United Nations Economic Commission for Latin America and the Caribbean, pointed out in a December 2 meeting with Econoff that private consumption had posted good growth for the second consecutive quarter. This consumption is being fueled in part by continued access to credit at lower interest rates available under new payroll deduction loans, which give banks greater assurance of being repaid. He argued that falling interest rates, when combined with stable employment and higher personal incomes, have created the conditions for a positive credit cycle that could sustain increased personal consumption, laying the foundation for stronger growth in 2006. This scenario gains credibility in light of a November poll which found consumer confidence to be at its highest level in recent years.

16. (SBU) Growth in 2006 also should benefit from a fiscal stimulus over the next six to eight months. Lula Chief of Staff Dilma Rousseff has led a political charge to force the Finance Ministry to spend (rather than save) any revenues above the primary surplus target, reportedly set informally by Lula and Palocci at between 4.6% and 4.7% of GDP (somewhat higher than the formal 4.25% of GDP target included in the budget). The GoB was running a primary surplus well ahead of this level (at least 5.1% of GDP in the first nine months of 2005), cushioned by better than expected tax revenues, which creates room for substantial end-of-year spending without endangering overall fiscal restraint. There also will be pressure to obligate as much money as possible during the first six months of the 2006 election year, after which point election-related limits on signing large new contracts go into effect until after the October 2006 election. The extent to which significantly increased expenditures on investment projects is possible is debatable, however, as the GOB's administrative capacity to spend is severely handicapped by its dysfunctional bureaucracy. While it is true that Palocci has been stingy in handing out funding to the ministries, many agencies have proven unable to spend a significant portion of the public investment monies they have received.

17. (SBU) Comment: Lula's more forceful recent backing of his finance minister and efforts to plaster over differences within his administration on fiscal policy mitigate the concern that Palocci might be forced out in a policy disagreement, despite the poor third quarter GDP result. While December 6 statements by Lula to the effect that there will be "adjustments" in GOB macroeconomic policy on the

surface sound ominous, in the end it will be the ultra-orthodox Ministry of Finance and Central Bank that implement any adjustment (likely in the manner they see fit). Palocci nevertheless remains vulnerable should evidence emerge to support the many allegations of wrongdoing made against him (refs B and C), as this would likely lead to his departure. Specifically, his upcoming mid-December appearance before the congressional committee investigating illegal bingo operations could prove particularly difficult. To date, his previous two congressional appearances have been softball affairs in front of the upper and lower house economic committees.

18. (SBU) Even political survival, however, may be cold comfort for Palocci should the economy continue to perform as poorly as it did last quarter. And, while there is clear potential for 2006 to be a better year for Brazilian economic growth than 2005 now looks to be, the falling investment trend and death of Lula's microeconomic reform agenda exacerbate concerns about the sustainability of robust growth levels. Look for continued middling economic performance from Brazil into the medium term.

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